United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-76-7616

To be argued by:
PREBEN JENSEN

United States Court of Appeals
For the Second Circuit

ROSALIE M. ARLINGHAUS, Executrix
of the Will of Frank H. Arlinghaus,
and ROSALIE M. ARLINGHAUS,
individually,

Plaintiff-Appellant,

against

J. RICHMOND RITENOUR and JOHN J. LIPSKY,

Defendants-Appellees,

and

MIRIAM PEPPER and SIDNEY PEPPER,

Defendants.

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On Appeal from the United States District Court for the Southern District of New York

APPELLANT'S BRIEF

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ERRATA IN APPELLANT'S BRIEF

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Plaintiff-Appellant,

-against-

J. RICHMOND RITENOUR and JOHN J. LIPSKY,

Defendants-Appellees,

-and-

MIRIAM PEPPER and SIDNEY PEPPER,

Defendants.

STATEMENT OF THE ISSUES PRESENTED FOR REVIEW

1. Was the district court in error in holding that the principal officers of the close corporation of which plaintiff, the widow and executrix of the founder of the corporation, was the major stockholder, discharged their duty under common law and under Section 10(b) of the Securities Exchange Act of 1934 to disclose to her, before buying a portion of her holding of the corporation's stock, their inside knowledge that the probable sale value of the

stock exceeded the price offered by them by 300 to 500 percent, by making such disclosure to plaintiff's attorney, who (A) as one of the purchasers of the plaintiff's stock had an adverse interest in the transaction and a motive for concealing the value of the stock from the plaintiff and (B) by his conduct during the period preceding the sale had given clear indication to the officers that he was not faithfully discharging his duties as attorney for the plaintiff but was seeking an opportunity to profit at her expense?

2. Was the district court in error in holding (A) that plaintiff must prove, as a prerequisite to recovery under Section 10(b) of the Securities Exchange Act of 1934, that she had exercised due diligence in ascertaining the value of the close corporation and (B) that plaintiff had failed to sustain that burden?

3. Having held that plaintiff's attorney had perpetrated a fraud upon plaintiff and otherwise violated his fiduciary duties to her in inducing the sale of her stock, was the district court in error in failing to hold the officers, who brought the major portion of the stock, jointly liable with the attorney for breach of his fiduciary duties?

STATEMENT OF THE CASE

Plaintiff, Rosalie M. Arlinghaus ("Mrs. Arlinghaus"), is the widow and the executrix of the will of Frank H. Arlinghaus, the founder of Modern Teleservice, Inc. ("Teleservice"), a close corporation. As executrix, she owned 20,360 of the 58,000 outstanding shares of Teleservice common stock. Individually, she owned 4,000 shares.

Appellee J. Richmond Ritenour ("Ritenour") was the president and appellee John J. Lipsky ("Lipsky") the

executive vice president of Teleservice. Defendant Sidney Pepper ("Pepper") was the general counsel of Teleservice and also the personal attorney for Mrs. Arlinghaus and the estate. Defendant Miriam Pepper ("Mrs. Pepper") is Pepper's wife.

After the death of Frank Arlinghaus, Pepper persuaded Mrs. Arlinghaus to sell to Ritenour, Lipsky and Mrs. Pepper all of her own and 40 percent of the estate's Teleservice stock for $10 a share. The total purchase price paid by the three defendants was $95,040. Approximately six months later, Pepper, Ritenour and Lipsky sold Teleservice to Sonderling Broadcasting Corporation ("Sonderling"). In that sale, they received Sonderling stock worth more than $60.00 for each share of Teleservice sold to them by Mrs. Arlinghaus. As the value of the Sonderling stock rose over the ensuing year, Ritenour, Lipsky and Mrs. Pepper liquidated a large portion of their holdings. At the time of the trial, Pepper, Ritenour and Lipsky had derived net profits well in excess of $650,000 on the Teleservice stock sold them by Mrs. Arlinghaus for $95,040.

In May, 1968 Mrs. Arlinghaus discharged Pepper as her attorney and retained other counsel. The circumstances of Pepper's discharge are related in Judge Frankel's opinion in the companion case, *First National Bank of Cincinnati v. Pepper*, CA 75-7519. Three months later, Mrs. Arlinghaus commenced the instant action to rescind her sale of Teleservice stock to Ritenour, Lipsky and Mrs. Pepper on the ground that the sale was induced by fraud, duress and violations of fiduciary duties. Against these claims Pepper set up a promise of a release which he had exacted from Mrs. Arlinghaus in connection with another transaction (the subject of *First National Bank of Cincinnati v. Pepper, supra*) but raised no other serious

defense. Ritenour and Lipsky claimed that the sale, as far as they were concerned, was a bona fide arm's-length transaction; that the concealments and violations of fiduciary duties with which the sale was unquestionably tainted were chargeable entirely to Sidney Pepper; and that they were blameless and, thus, entitled to enjoy their shares of the fruits of Pepper's wrongdoing.

The action was tried to Judge Henry Werker, without a jury. Judge Werker rendered his decision on August 27, 1975. He found that Mrs. Arlinghaus had made the sale in "total reliance" upon Pepper (A 38) and that Pepper had misrepresented facts to and concealed facts from Mrs. Arlinghaus and had thereby violated his fiduciary duties to her. (A 42). The agreement for a general release having been rescinded by Judge Frankel in the companion action on August 6, 1975, Judge Werker dismissed the affirmative defense based on that release and directed entry of judgment in favor of Mrs. Arlinghaus against Pepper, awarding compensatory and punitive damages. Judge Werker directed Pepper to account for his profits and referred the accounting to Magistrate Charles J. Hartenstine, Jr. Judge Werker dismissed the action as to Ritenour and Lipsky by a judgment entered pursuant to Fed. R. Civ. P. 54(b) on September 30, 1975. The instant appeal is taken from that judgment.

At a pre-argument conference in the companion action, Pepper made known his intention to appeal from the judgment eventually to be entered against him on the accounting in the instant action. Consequently, in order to effect economies of time and effort for the Court and the parties by consolidation of the two appeals, which involve the same record and many of the same issues, Mrs. Arlinghaus made, and this Court granted, successive motions to defer briefs and argument herein until entry of

judgment against Pepper. When no decision had been rendered by Magistrate Hartenstine, and therefore no judgment had been entered against Pepper, by May 20, 1976, this Court declined to adjourn further the instant appeal. See the order of the Clerk of the Court dated May 24, 1976.

THE FACTS

Frank H. Arlinghaus organized his first corporation, Modern Talking Picture Service, Inc., in 1936 or 1937. (A 292). The business of that corporation was to distribute sponsored films. When television became an important media factor in the early 1950's, Arlinghaus created a separate division in Modern Talking Picture Service, Inc. to process and distribute television commercials for advertising agencies. (A 251-252). He selected Ritenour to organize the new division and become its "director". (A 251; Exh. E, p. 15). Lipsky became manager of the division. (A 226). When new markets opened up on the West Coast, Ritenour picked Lipsky to establish and run the division's second major office in Los Angeles. (A 226-227).

The television service division grew, and, in 1956, Arlinghaus spun off that division as a separate corporate entity, Modern Teleservice, Inc., organized under the laws of the State of New York. (Pre-Trial Order, p. 2). Ritenour and Lipsky were given the entire management of the corporation. Arlinghaus retained for himself only the title of chairman of the board. (*Id.* 2-3). Ritenour and Lipsky "were" the corporation (E 178; A 108-109), Ritenour as president (E 123) and Lipsky as vice president. (A 226; A 227-229). Between them they had originated the major accounts. (*Ibid.*). Upon the death of Frank Arlinghaus in 1964, their dominance was total.

Pepper, whose firm was counsel to both of the Arlinghaus corporations from their inception (A 58; A 135-136), rendered all of the legal services required by the corporations. (A58; A292). Upon the death of Frank Arlinghaus, a New Jersey resident, in 1964, Pepper's senior partner, Benjamin DeWitt, who was admitted to practice in New Jersey, was retained as attorney for the estate. (Trial Transcript, 304-305). When DeWitt died the following year, Pepper succeeded him as counsel to both the estate and Mrs. Arlinghaus. (*Ibid.*)

A physical therapist with no business experience whatsoever, Mrs. Arlinghaus had had no contact with Teleservice and had received only the most cursory reports of its business. (A 100; A 142-143). She relied entirely on Pepper, in whom she had trust and confidence. (A 141-142). Not only was she not a director,* but she did not even attend the 1967 stockholders meeting, the first such meeting in the history of the corporation. (E 124). Her brother-in-law, Clem Arlinghaus, was a director of Teleservice but had little knowledge and no understanding of the corporation's business. (A 55-61; A 75).

Defendants' purchase of Teleservice stock from Mrs. Arlinghaus was engineered by Sidney Pepper during the month of June, 1967. It followed an unsuccessful attempt on the part of Ritenour and Lipsky earlier that year to purchase the company without Pepper's participation. The events leading up to the first, abortive purchase have an important bearing on the issues presented herein. We shall relate those events below and shall turn thereafter to the purchase for the rescission of which this action is brought.

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*Mrs. Arlinghaus, together with Pepper's secretary, was elected to the "wind-up" board of directors a few weeks before Teleservice passed out of existence. (Trial Transcript, 379).

A. *The Unsuccessful Purchase at $20 a Share.*

The Teleservice shares were restricted by a stockholders' agreement which was signed in 1956 and which expired in October, 1966. (E 72-98). The agreement gave the estate the right to put its Teleservice stock in whole or part to the corporation. (*Ibid.*). This right survived the expiration of the agreement and could have been exercised until August, 1967. (*Ibid.*).

In two meetings held late in December, 1966, Sidney Pepper, Clem Arlinghaus and Mrs. Arlinghaus considered whether to sell all or part of the stockholdings of the estate. (A 62-66; A 102). These discussions were occasioned by the news that the IRS had made an additional assessment of estate tax in the amount of $80,000. (*Ibid.*). At the first of the two meetings someone said that it "might be desirable" to put the Teleservice stock to the corporation in order to raise the necessary funds, provided that the formula price would be "$20 or better a share". (A 62). What was suggested was not a put of all of the stock but of just enough of the stock to cover one half of the entire tax assessment. The other half would come from a put of the stock of the sister company, Modern Talking Picture Service, Inc. (E 186). In preparation for the second meeting, Clem Arlinghaus sent to Mrs. Arlinghaus, Pepper and Milton Lewis (another director who was to attend that meeting) a separate agenda in which he stated as his own viewpoint that the question of the sale of the estate's stock should be postponed, in particular as far as the Teleservice stock was concerned (*ibid*); and it was in fact decided at that meeting *not* to exercise the put but to find a source of credit "rather than force a sale of the stock". (A102; Trial Transcript, 87). Borrowing was a feasible alternative: the record shows, in a different context, that the Teleservice

stock evidently would have been acceptable security for a loan by the Chase Manhattan Bank, which handled the corporation's banking business. (A 231). The net result of the two meetings was that the question of the sale of the Teleservice stock was postponed. It was Mrs. Arlinghaus' feelings, as Clem understood them, that the company was a satisfactory investment for the time being inasmuch as it "was prospering, it was doing well. . . ." (A105-106). This is how matters stood until April 25, 1967. (A102).

Because of the company's need to grow, the board of directors of Teleservice, at one of its meetings in 1966, authorized Ritenour and Lipsky to go out and "survey the field" in order to find a merger partner or purchaser for the company. (E 214-216; Finding No. 5). Judge Werker found that Ritenour and Lipsky held several exploratory meetings with brokers and that Ritenour reported the fact and results of those meetings to the board of directors and to Pepper, as counsel for Teleservice and for Mrs. Arlinghaus. (Finding No. 5; A34). On or about December 19, 1966, Ritenour asked that he be authorized to discontinue his efforts, saying he did not believe he could get an offer at an acceptable price. (E168; Exhibit E, p. 154). By that time, as subsequent events showed, Ritenour and Lipsky had decided to capture for themselves the value of the corporation above the formula price. Their continued exploration of the market place proved, much before their purchase of stock from plaintiff, that the actual value of the Teleservice stock was several times the formula price under the stockholders' agreement. In the words of Judge Werker, "negotiations for the sale of MTS indicated a probable corporate value of two to three million dollars." (Conclusion No. 3; A42). The probable value of a share of Teleservice, then, was $34 to $51. All of this was concealed from Mrs. Arlinghaus until after her sale of

Teleservice stock to Ritenour, Lipsky and Mrs. Pepper. (*Ibid.*).

The primary brokers with whom Ritenour and Lipsky dealt during 1967 were Harris Shapiro, who operated under the style of Commonwealth Development Corporation, and Shapiro's New York affiliate, Gray Associates. (LD 30-34). These negotiations took place shortly after Ritenour had sought to withdraw from the assignment, given him by the board of directors (*supra*), to find a purchaser for Teleservice.

Shapiro was immediately interested and, in short order, produced a syndicate of investors, headed by Lewis Stat, who, also in short order, agreed to buy all of the stock of Teleservice. (E 131-135; A 242; Trial Transcript 111-112; E44-45). When the tender offer was made on April 25, 1967 it was made in the names of Ritenour and Lipsky. The stipulated price was $15. The offer by its terms was to expire within 17 days. (E2). No mention of the syndicate was made until May 10, 1967, just two days before the expiration of the tender offer. (A79-80). The identity of its members was never disclosed. (A87).

The confidential agreement between Ritenour, Lipsky and Stat under which Ritenour and Lipsky undertook to attempt to buy Teleservice from the stockholders provided that, if Ritenour and Lipsky should succeed, they were to receive 25 percent of the difference between the purchase price and $1,200,000 and that Stat's syndicate, in addition, was to "gift" 12½ percent of the stock to each of the two defendants. (E44-45). Stat added the following telling postscript to the confidential agreement:

> "P.S.
> It is my understanding that you will introduce me to the attorney for the estate [Pepper] in the event you fail to purchase the stock at the low price. L.S. [Lewis Stat]" (*Ibid.*).

The postscript shows that Ritenour and Lipsky had represented to Stat, and convinced him, that $1,200,000 was a "low price" for him to pay for 75 percent of the stock.

It is also clear from the postscript that Stat, Ritenour and Lipsky knew that it might be necessary to obtain Pepper's cooperation in order to buy at the low price. The confidential agreement, of course, was never shown to Mrs. Arlinghaus; nor was she ever told of its provisions. (A238; E136-137). Lipsky told Mrs. Arlinghaus in his one meeting with her that he and Ritenour were "not asking for anything for free; we were willing to buy anything that would give us ownership in the company." (E207-208). This was untrue. The only thing Ritenour and Lipsky had to deliver for their 25% interest in the company was plaintiff's (and the other stockholders') agreement to sell "at the low price." (E44-45; A237-238).

Counsel for Ritenour and Lipsky suggested at the trial that the stock ownership Ritenour and Lipsky were to enjoy under the syndicate agreement was part of an "employment package." (Trial Transcript 291). In fact, Lipsky and Ritenour entered into a separate agreement for a five year employment contract, which included possible stock options. (E205-206). The confidential agreement was clearly a brokerage agreement. The benefits conferred in it on Ritenour and Lipsky were their compensation for bringing the purchase about—at the "low price."

Some time between March 14 and April 25, 1967, Pepper came to Ritenour and Lipsky with the suggestion that he, Pepper, put pressure on his client to sell by using the threat that Ritenour and Lipsky would resign unless she agreed to sell. (A110; LD 62). Ritenour testified at the trial that he had told Pepper not to use "such devious methods." (A111; Exhibit M; pp. 62-63). Pepper, however,

did tell Mrs. Arlinghaus, repeatedly, that Ritenour and Lipsky had threatened to resign and take the important accounts with them if she didn't sell, leaving her with nothing "but wallpaper and film winders". (A145-146; A149-150; A204-205; A229-230). Pepper also told Clem Arlinghaus he was convinced Ritenour and Lipsky would pull out if the sale was not made. (A67; A84).

At the trial Ritenour attempted to cleanse himself and Lipsky of Pepper's actions in this respect. He testified that he and Lipsky had told Mrs. Arlinghaus, in the presence of Clem Arlinghaus and Pepper at a luncheon on May 10, 1967, that it was not true that he and Lipsky would quit if Mrs. Arlinghaus should refuse to sell to them. (A126-129). Lipsky's deposition testimony contradicted Ritenour's testimony in this respect. (E209; A230; Trial Transcript, 270-271). Mrs. Arlinghaus testified that she heard nothing at the luncheon to dispel the threats and that, months later, Ritenour had refused to deny that he had made such threats. (A214-218)*. Faced with these and other contradictions, Judge Werker made a non-too-confident finding that Ritenour's version of the conversation was the most credible; but Judge Werker immediately modified that finding by pointing out that, in view of Sidney Pepper's previous statements, Mrs. Arlinghaus "may have taken [Ritenour's and Lipsky's] eagerness to combine [Teleservice] business control and ownership as an indication that they would seek such a combination elsewhere if necessary." (A36).

As a result of the May 10, 1967 luncheon, the price was increased to $20. Mrs. Arlinghaus accepted the offer on May 12, 1967. (Exhibit 2; Trial Transcript, p. 55).

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*Ritenour conceded at the trial that such an incident might have occurred. (Trial Transcript, p. 374).

The sale to the syndicate fell through when on the closing day, June 9, 1967, the syndicate did not produce the money. Stat asked for an extension of time, assuring Pepper he could raise the funds (E140; E167), but Pepper, without consulting Mrs. Arlinghaus, who was not present at the closing (Exh. F, pp. 90-91), refused to grant Stat an extension (*id.;* E140); for he now finally saw his opportunity to obtain a piece of the action. He had been chagrined that the $20 purchase offer of April 25, 1968 had not included any compensation to him "for acting as agent in the transaction" with his client (E169), although he had nourished a "hope" to the end that somebody, as he put it, "would be generous and realize that I still had to make a living." (Exh. F, p. 137). When he saw the syndicate closing fail, Pepper conceived some different ideas. In pursuance of those ideas, Messrs. Ritenour, Lipsky and Pepper were within a few weeks to buy stock from Pepper's client, not at $20 a share, but at $10 a share.

B. *The Successful Purchase at $10 a Share*

After the failure of the syndicate to buy, Pepper entered into conversations with Ritenour and Lipsky in an effort to work out a plan for their purchase of the Arlinghaus stock (E142-145; A230; Trial Transcript, p. 404), guiding them and giving them legal counsel (E151; E145). Pepper's first stipulation in these discussions was that, this time, he would have to be paid a fee "for his work in consummating the thing." (Exhibit F, pp. 134-135). Considering this point settled, he proceeded to engineer the sale in complete disregard of his client's interest in obtaining a fair price for her shares. Thus, when Ritenour suggested paying $7.50, Pepper's objection was, not that this price was less than the value of the stock, but that it was even lower than the estate valuation, which was "pretty close to $10 a share." (E172). The ten dollar 1964 estate tax valuation, then, and not the

1967 market value or any other fair measure of the value of the stock, became the target price. Clearly this price was decided on because it was the lowest price Pepper thought he could get away with and not because it was the fair price Mrs. Arlinghaus and the estate should obtain for their stock. The record is clear that Pepper, Ritenour and Lipsky knew by this time that the true value of the shares was between $34 and $51. See Judge Werker's findings, *supra.*

Pepper devised the purchase formula and drafted the proposal. (A122). In the process, Pepper dropped the idea of a commission for himself and instead, for tax reasons (Trial Transcript, p. 406), obtained a share of the stock purchase for his wife, thus acquiring an even more pronounced personal interest in the transaction. (A118-119; A154-155; A232-233). After the formulation of the $10 proposal, Ritenour and Lipsky heard that Pepper continued to rumor to Mrs. Arlinghaus that Ritenour and Lipsky were threatening to resign; but they neither contacted Mrs. Arlinghaus to set the record straight nor told Pepper to do so. (Finding No. 12, A38; Op., fn. 6, A50).

Neither Ritenour nor Lipsky dealt directly with Mrs. Arlinghaus. (A120; A242). It was Pepper who presented the proposal to Mrs. Arlinghaus and persuaded her to accept it. (A153). Needless to say, Pepper did not discuss the adequacy of the $10 price with plaintiff. (Exhibit M, pp. 181-182). She did not know the value of her holdings at the time of the purchase agreement. (AT 178).

The purchase agreement took the form of two letters dated June 30, 1967 from Pepper to Mrs. Arlinghaus, which were countersigned by Mrs. Arlinghaus, together with two letters from Ritenour dated July 1, 1967. (E51-58).

Under the terms of the purchase, Mrs. Arlinghaus was to

receive $3.00 cash and $7.00 in deferred payments. She was never to receive another dollar from any of the defendants but was given the option to repurchase the stock at the $10 price unless the company should be sold within one year at a price which, when added to the sums paid her, by defendants, should produce to her an average price of at least $20 a share for the entire original Arlinghaus holdings. (*Ibid.*). In order to yield this result, the company would have to be sold at a price which would bring at least $27 a share. (A225). In other words, Ritenour and Lipsky were paying $10 for stock which two months earlier they had agreed to buy at $20 and, by granting plaintiff the repurchase right, they showed their knowledge that the shares which they bought for $10 would bring at least $27. Thus, the very terms of the purchase agreement shows that it was entered into through compulsion or deceit or undue influence. It is simply absurd to suggest that such an agreement could be accepted voluntarily by a person in possession of all of the facts, capable of understanding its terms and not subject to undue influence.

An understanding with Fuqua Industries, Inc. for the sale of Teleservice for a price equal to $51 a share was under negotiation within weeks of the effective date of the purchase, if not earlier (A235; E153-154), and was concluded on November 17, 1967. When Fuqua reneged on the agreement in February, 1967, Sonderling Broadcasting Company immediately stepped into the breach and, on March 25, 1968, concluded an agreement to purchase Teleservice. (A294). The sale to Sonderling was consummated two weeks later. The selling stockholders received 130,000 shares of Sonderling capital stock in exchange for the outstanding Teleservice shares. (Pre-Trial Order, p. 6). The market value of 130,000 shares of Sonderling on April 8, 1968 was $3,867,500 (E64).

JUDGE WERKER'S OPINION

In her first claim Mrs. Arlinghaus alleged that her sale of Teleservice stock to Ritenour, Lipsky and Pepper had been induced by threats that Ritenour and Lipsky would resign as officers of Teleservice if she did not sell. Judge Werker dismissed that claim on the basis of (1) Mrs. Arlinghaus' testimony that the threats had been made through Pepper and that Ritenour and Lipsky had never made threats directly to her and (2) his finding that Ritenour and Lipsky had disavowed the threats to Mrs. Arlinghaus. (A41).

Plaintiff alleged in her second claim that Ritenour and Lipsky had concealed from her their findings as to the value of Teleservice. Judge Werker dismissed that claim, holding that Ritenour and Lipsky had reported to Pepper on such matters and could reasonably assume that the information which they had given Pepper would be imparted to Mrs. Arlinghaus by Pepper. (A41).

In her third claim, plaintiff alleged that Pepper had violated fiduciary duties by representing to her that Ritenour and Lipsky would resign if she refused to sell to them and by concealing from her the probable sale value of the corporation. Judge Werker found Pepper liable on both scores. (A42-43).

Plaintiff alleged in her fourth claim that defendants had acted in concert and pursuant to a conspiracy in purchasing her shares. Judge Werker found that there was no agreement, express or implied, among defendants to defraud plaintiff. Therefore, he dismissed the fourth claim. (A43-44).

Finally, plaintiff alleged that defendants were liable under Section 10(b) of the Securities Exchange Act of 1934 for failing to disclose material information *i.e.* their

knowledge about the probable sale value of the corporation. In passing on this claim Judge We[illegible] repeated his holding that Ritenour and Lipsky had made full disclosure of all material facts to plaintiff by making such disclosure to Pepper as [illegible]er agent. He also held that plaintiff had not made out a claim against Pepper for liability under Section 10(b), inasmuch as, in his view, she had failed to exercise due diligence in ascertaining the value of the corporation. (A45).

POINT I

THE LOWER COURT ERRED IN HOLDING THAT RITENOUR AND LIPS[illegible]Y DISCHARGED THEIR DUTIES TO M[illegible] ARLINGHAUS BY REPORTING TO PEPPER THEIR KNOWLEDGE AS TO THE PROBABLE VALUE OF TELESERVICE

Judge Werker found that the probable value of the company, as established by defendants' probing of the marketplace, was concealed from Mrs. Arlinghaus. (A 43). He blamed that concealment on Pepper, holding that Pepper was "liable to plaintiff for concealing from her the fact that negotiations for the sale of MTS indicated a probable corporate value of $2-$3 million." (*Ibid.*)

It was, of course, Ritenour and Lipsky who had primary knowledge about the probable corporate value. Nonetheless, Judge Werker refused to find them liable for concealment. He held that the reports which they had made to Pepper were made to him as attorney for Mrs. Arlinghaus and that Ritenour and Lipsky "had no duty to repeat to plaintiff information they could reasonably

assume would be imparted to her by her attorney." (A 41). In support of this holding he cited *Myzel v. Fields*, 386 F. 2d 718 (8th Cir. 1967). (*Ibid.*) He further held that, once the $10 offer had been made, Mrs. Arlinghaus was on notice that her attorney was also acting for a party on the other side of the transaction and that Mrs. Arlinghaus was, therefore, estopped from denying that she had knowledge of Ritenour's and Lipsky's disclosures to Pepper. (*Ibid.*) The adverse party for whom Pepper was acting was, of course, Miriam Pepper or, for all practical purposes, Pepper himself. See *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 841 n. 4 (2d Cir. 1968). For that holding Judge Werker relied on *Mittendorf v. Williston & Beane, Inc.*, 372 F. Supp. 821 (S.D.N.Y. 1974). (*Ibid.*).

It is respectfully submitted that, in making these holdings, Judge Werker misapplied the rules of the law of agency.

A. Insofar as he sought to characterize the duty of Ritenour and Lipsky to disclose material inside information, Judge Werker was in error in relying upon *Myzel v. Fields, supra.* Rather than enunciate a rule of agency law which would support his holding that Ritenour and Lipsky had discharged their duty of disclosure by reporting to Pepper, the decision in *Myzel* is primarily concerned with the "control" relationship between defendants under §20(a) of the Securities Exchange Act of 1934, 15 U.S.C. §78t.

B. The rule that notice to the agent is notice to the principal rests on the presumption that the agent will perform his duties, one of which is to disclose to the principal material information at his command. *Benedict v. Arnoux*, 154 N.Y. 715, 729 (1898). That presumption disappears just as soon as the agent forms the purpose of

dealing with the principal's property for his own benefit and advantage. *Ibid.* In so holding, the New York Court of Appeals quoted with approval from Pomeroy on Equity Jurisdiction:

> "Mr. Pomeroy says in his work on Equity Jurisprudence:
>
> 'When an agent or attorney has in the course of his employment been guilty of an actual fraud, contrived and carried out for his own benefit, by which he intended to defraud, and did defraud, his own principal or client, as well as perhaps the other party, and the very perpetration of such fraud involved the necessity of his concealing the facts from his client, then, under such circumstances, the principal is not charged with constructive notice of facts known by the attorney, and thus fraudulently concealed.' §675." 154 N.Y. at 730.

Similarly, when the agent acts in his own interest, his knowledge will not be imputed to the principal. *Herdan v. Hanson,* 182 Cal. 538, 189 Pac. 440, 443 (1920); *Owens v. Schneider,* 29 Cal. App. 2d 593, 85 P.2d 198, 199 (1938).

In other words, when the agent is himself one of the third parties with whom he is dealing on behalf of his principal or the agent is engaged in a fraud upon the principal (both of which were true in the instant case), the agent's knowledge will not be imputed to the principal.

In *Mittendorf v. Williston & Beane, Inc., supra,* plaintiff sought to recover a loan arranged by Norman Marsh, who served as agent for both plaintiff and defendant. In such a case of dual agency the agent's knowledge ordinarily will not be imputed to the principal, since the dual agency constitutes a violation of the agent's duties to the principal. That rule, however, is not followed where the principal consents to the agent's acting for the other party as well. Judge Pollack found that Mittendorf

had known that Marsh was an officer of defendant, and Judge Pollack therefore held that Marsh's knowledge must be imputed to Mittendorf. (*Id.*, p. 829). Significantly, Judge Pollack went to great lengths to point out that, in arranging for the loan from Mittendorf to his employer, Marsh was acting in perfectly good faith; that Mittendorf in his testimony had exonerated Marsh from any suggestion of dereliction of duty; that no implication or inference of deceit could be drawn from the evidence; and that any criticism of the wisdom of making the loan did not justify a conclusion that Marsh was actuated by bad faith. 372 F. Supp. at 829. Only after thus carefully scrutinizing the conduct of the agent did Judge Pollack hold that Marsh's knowledge was imputable to Mittendorf. (*Ibid.*) Clearly, if Judge Pollack had found evidence that Marsh had perpetrated a fraud upon Mittendorf, as Pepper did upon Mrs. Arlinghaus, he would have refused to impute Marsh's knowledge to Mittendorf. Judge Werker failed to perceive this distinction.

The interplay of the imputation rule for a disclosed dual agency and the non-imputation rule for fraudulent conduct is well illustrated by *Farr v. Newman*, 14 N.Y. 2d 183, 250 N.Y.S. 2d 272 (1964), currently the leading New York authority on the subject.

Farr, represented by an attorney, had entered into an oral agreement to buy land owned by Newman. Subsequently, Newman conveyed the land to defendant Hardy, who was represented by the same attorney that had represented Farr. The attorney, who believed Farr's oral contract to be unenforceable, had not told Hardy of Farr's contract. Farr brought the action to have Hardy convey the property to him, contending that Hardy had known of the attorney's dual agency and that, therefore, the attorney's knowledge of Farr's contract was imputable to him.

Hardy sought to avoid imputation by invoking the rule in *Benedict v. Arnoux, supra,* that a deceiving agent's knowledge will not be imputed to the principal. The Court of Appeals refused to apply that rule in the case before it, since the trial court had found no deceit. In language which was subsequently paraphrased by Judge Pollack in *Mittendorf v. Williston & Beane, Inc., supra,* the Court said:

> "* * * Binding on this appeal is the finding of fact, made by the trial court and affirmed by the Appellate Division, that the attorney believed in good faith that plaintiff's contract was unenforceable. That this belief was not without foundation is demonstrated by the holding of the trial court that the memorandum was insufficient under the Statute of Frauds. (The Appellate Division reversed this finding in an opinion in which we concur.) The attorney's sincere belief in the unenforceability of plaintiff's contract precludes even a preliminary consideration of the applicability of the fraud cases to this case. It is certainly within the authority of an attorney to pass on legal questions potentially affecting the title of the purchaser whom he represents. Any criticism of the wisdom of consummating the transaction in the face of a threat of a lawsuit does not justify the conclusion that the attorney's decision to proceed was actuated by bad faith-in the face of a contrary finding by the trier of the facts.
>
> "It is well-settled that the principal is bound by notice to or knowledge of his agent in all matters within the scope of his agency although in fact the information may never actually have been communicated to the principal (Howell v. Mills, 53 N.Y. 322; McCutcheon v. Dittman, 164 N.Y. 355, 58 NE 97; Ratshesky v. Piscopo, 239 Mass 180, 131 NE 449). Where, as here, there is a mere error of judgment on a legal question which the attorney had the professional responsibility of resolving, the

> rule that such knowledge is imputed to the principal applies (McCutcheon v. Dittman, supra; Howell v. Mills, supra). Here the attorney was employed to pass judgment on the state of the title by both parties. When he made a decision on which judges have differed, it can hardly be found to be deceitful as a matter of law." 14 N.Y. 2d at 187.

By contrast, in the case at bar Judge Werker found that the agent, Pepper, was guilty of such flagrant deceit and violations of fiduciary duties as to call for the imposition of punitive damages. Clearly, then, Judge Werker was in error in imputing to the principal, Mrs. Arlinghaus, the knowledge which, as Judge Werker found, Pepper had concealed in order to effectuate his fraud.

After holding that no fraud had been shown, the judge (Burke, J.) writing for the majority in *Farr v. Newman, supra,* went on to suggest, by the way of dictum, that the fraud rule should not be applied where (as in the case of the equitable lien involved in *Farr)* the substantive law relied on requires notice, only, as distinguished from actual knowledge, to bind the principal. He found a parallel in the rule of Restatement 2d of Agency §271, which reads:

> "A notification by or to a third person to or by an agent is not prevented from being notice to or by the principal because of the fact that the agent, when receiving or giving the notification, is acting adversely to the principal, unless the third person has notice of the agent's adverse purpose."

While the dictum by Judge Burke cannot be construed as an adoption by the New York Court of Appeals of the rule of the Restatement, especially for a case such as the instant one, where the substantive rule of law requires knowledge and not simply notice, it is clear that, even under the rule of the Restatement, the Court would have to refuse to impute

Pepper's knowledge to Mrs. Arlinghaus; for that rule prohibits imputation where "the third person has notice of the agent's adverse purposes." (*Ibid.*). If anything is established to a certainty by the record in the instant case, it is that Ritenour and Lipsky knew at the time of the $10 purchase that Pepper was not a faithful agent for Mrs. Arlinghaus but was bent on feathering his own nest at the expense of his clients and would stop at nothing to accomplish that purpose. They had observed his machinations at first hand:

1. In the "hope" of obtaining a brokerage fee for arranging the sale of the assets of the estate and the widow whom he represented to the Stat syndicate in May, 1967, Pepper had proposed using threats and pressure to bring about the sale. Ritenour and Lipsky understood very well that Pepper's proposal was improper: they testified that they turned down his proposal in no uncertain terms. (Pp. 10-11, *supra*).

2. Ritenour and Lipsky subsequently learned that, in disregard of their injunctions not to threaten Mrs. Arlinghaus with resignations, Pepper had done exactly that in his attempt to bring about the sale to the syndicate, from which he hoped to make a profit. At this time, then, Ritenour and Lipsky knew not only that Pepper had the propensity and intent unduly to influence his client but also that he was in fact lying to her in order to induce the purchase. They were so highly cognizant of the impropriety of this approach that, as they testified, they felt impelled to disavow the threats to Mrs. Arlinghaus in person. On this occasion, then, they saw the need for dealing directly with Mrs. Arlinghaus to ensure that the negotiations were handled properly in spite of Pepper's proclivities. (*Supra*, p. 11).

3. The very fact that Pepper sought to engender a commission for himself in dealing with his client's property was a clear reflection of Pepper's unfaithfulness. (*Supra*, p. 12).

4. Ritenour and Lipsky knew that the probable value of a share of Teleservice was $34 and $51, and they knew that Pepper knew it. They observed how, in spite of his knowledge of the true value of his client's stock, he did not endeavor to bargain for the true value, or anything approaching it, but, on the contrary, sought to effect the purchase at the lowest value he thought possible. This action, too, gave clear indication that Pepper was acting against his client's interests. (*Supra*, pp. 12-13).

5. The very fact that Pepper added his wife as one of the purchasers, at the bargain price (one-half of Stat's "low price", see pp. 9-10, *supra*), was a clear indication to Ritenour and Lipsky that Pepper was taking advantage of Mrs. Arlinghaus' blind trust in him to victimize her. The circumstances under which Mrs. Pepper became a purchaser, as related by Ritenour and Lipsky themselves at the trial and in their deposition testimony, show a particularly repulsive species of self-dealing. It is clear from their testimony that Pepper, to put it plainly, lined up to "join in the getting while the getting was good." Knowing that Pepper, as a purchaser, had acquired a direct personal interest and an identification with them, Ritenour and Lipsky were, again, put on notice that their duty of disclosure to Mrs. Arlinghaus could not be discharged through Pepper. (*Supra*, p. 13).

6. Besides having acquired an identity of interest with them conflicting with that of his client, Pepper was beholden to them as counsel to the corporation of which they were the chief officers. (*Supra*, p. 6).

7. Finally, Pepper showed at every turn that he was sponsoring Ritenour's and Lipsky's interests, which he considered as his own, and was ready and willing to act contrary to the interests of his clients. (*Supra*, pp. 12-14).

On this record, the only conclusion that can be drawn is that Ritenour and Lipsky were not justified in assuming that information about the probable value of the company, which exceeded the proposed purchase price by 300 to 500 percent, would be imparted to Mrs. Arlinghaus by Pepper. To rely on Pepper in this respect was to send the wolf to guard the sheep. Ritenour and Lipsky clearly understood that they could discharge their duty of disclosure only by bypassing Pepper, as they had done at the time of the proposal by Stat's syndicate, and communicating directly with Mrs. Arlinghaus.

To sum up, the general presumption that notice to an agent is notice to his principal, *Benedict v. Arnoux, supra*, is not applicable when the agent conceals those facts from his principal in order to defraud him, *ibid.*, or when the agent is also acting on his own behalf in the transaction. *Herdan v. Hanson, supra.* The mere fact that an agent acts in a dual capacity, *i.e.* on behalf of both parties to a given transaction, is by itself not sufficient evidence of an agent's fraud to rebut the presumption of notice when the principal is aware that the agent is acting in the dual capacity, *Mittendorf v. Williston & Beane, Inc., supra; Farr v. Newman, supra.* However, when the agent is guilty of actual fraud, the agent's knowledge will not be imputed to the principal under the rationale of *Mittendorf* and *Farr*. Even under the Restatement of Agency principle, Ritenour's and Lipsky's disclosures to Pepper could not be considered constructive disclosure to Mrs. Arlinghaus, for they were well aware that Pepper was acting dishonestly and deceitfully toward Mrs. Arlinghaus. Consequently,

they should be required to make restitution of their profits from the transaction, a remedy which does nothing more or less than deprive them of their gains from Pepper's and their own wrongful conduct.

POINT II

AS OFFICERS AND DIRECTORS OF TELESERVICE, RITENOUR AND LIPSKY HAD A DUTY TO DISCLOSE MATERIAL FACTS TO THE STOCKHOLDER WHOSE SHARES THEY SOUGHT TO BUY

Mrs. Arlinghaus claimed that in concealing the value of Teleservice from her, defendants Ritenour and Lipsky violated the obligations of full disclosure and good faith owed to her by them as officers and directors of Teleservice.

Judge Werker held that Ritenour and Lipsky were not liable on this claim because, rather than conceal information, they made routine reports to Pepper as attorney for Mrs. Arlinghaus. In so holding, Judge Werker acknowledged that Ritenour and Lipsky were under a duty to make disclosure to Mrs. Arlinghaus of their knowledge of the probable value of Teleservice.

The fiduciary duty of Ritenour and Lipsky derived (1) from the fact that they were officers and directors of Teleservice and (2) from the provisions of Section 10(b) of the Securities Exchange Act of 1934.

A. *The Disclosure Duty of Officers and Directors*

The common law duty of an officer or director when purchasing shares from a shareholder of the corporation whom he serves is well defined. At one time a majority of the states adhered to a rule permitting arms-length

dealings, while a minority imposed the duties of a fiduciary on an officer *vis a vis* a shareholder-seller. Because the former rule led to harsh and manifestly unjust results, most of the courts which followed it have instead adopted the so-called "special circumstances" doctrine, which allows the court to apply the "minority" fiduciary standard whenever the court finds that the circumstances of the case warrant it:

> "In actual results the 'old majority' rule has substantially merged into the 'special circumstances' doctrine which in turn is scarcely distinguishable from the so-called 'minority' rule. Although one does not begin in the 'majority' or 'special circumstances' jurisdiction with the premise that insiders are fiduciaries, the 'special circumstances' doctrine is manifestly based on the existence of a relationship between director and stockholders which is different from the relationship between arms-length traders. In *Strong v. Repide* [213 U.S. 419 (1909)] the "special circumstances' were found in the fact that the defendant had been entrusted with the negotiations to sell the corporate assets; but certainly if he had not been a director he never would have had an affirmative duty to make disclosure. In other jurisdictions, similarly, the 'special circumstances' are commonly no more substantial. Thus, the Michigan Court described them in 1925 as any 'fact or condition enhancing the value of the stock, known by the officer or officers, not known by the stockholder, and not to be ascertained by an inspection of the books."
> [*Buckley v. Buckley*, 230 Mich. 504, 508, 202 N.W. 955, 956 (1925)].
>
> "It seems fair to conclude from all this that the so-called 'majority' view is gradually giving way to the generally growing feeling of responsibility of corporate insiders-in the development of a status of

> 'trusteeship' in a non-technical sense."
> *Loss, Securities Regulation,* pp. 1447-1448 (2nd Ed. 1961).

In New York, the relationship between a stockholder and director is in a sense fiduciary. *Von Au v. Magenheimer,* 126 App. Div. 257, 110 N.Y.S. 629 (2d Dept. 1908), *aff'd.,* 196 N.Y. 510, (1909). New York is among the "special circumstances" jurisdictions and imposes liability not only for active fraud but also for active concealment. *Lesnik v. Public Industrials Corporation,* 144 F.2d 968, at 977 (2d Cir. 1944); *Cochran v. Channing Corporation,* 211 F. Supp. 239 (S.D.N.Y. 1962); Fletcher, Cyclopedia of the Law of Private Corporations, Section 11 '1, at pp. 865-866.

The leading "special circumstances" decision in New York is *Saville v. Sweet,* 234 App. Div. 236, 254 N.Y.S. 768 (1st Dep't 1932), *aff'd.* 262 N.Y. 567, (1933). In that case the Appellate Division, First Department considered the relationship between plaintiff, the administratrix of the estate of the former president of Rogers & Mason Company, and the defendants, who were officers and directors of that company. The Court made the following holding:

> "It is not necessary for the plaintiff to establish a technical case of fraud and deceit. The relationship between plaintiff and the defendants was like that of a fiduciary. Defendants were the directors and officers of a very small corporation, whose stock was not listed or traded in anywhere, whose business was small and known only to themselves, and who, in purchasing control from plaintiff, were under a duty to disclose to her the full facts of the condition of the company affecting the value of the stock which she was selling." (234 App. Div. at 238, 254 N.Y.S. at 770).

The Court of Appeals affirmed, without an opinion. 262 N.Y. 567, 188 N.E. 67.

The facts of the instant case are indistinguishable from the "special circumstances" described in *Saville v. Sweet, supra.* Defendants here were officers and, in the case of Ritenour and Lipsky, directors of a small corporation, Teleservice, whose stock was not listed or traded anywhere and whose business was small. While in *Saville* the undisclosed knowledge related to the earnings of the company, the duty of disclosure is by no means limited to facts relating to the finances of the corporation. Failure to make full disclosure of negotiations for sale of the corporation or its assets or misrepresentations as to the true value of the corporation also require recission. See *Strong v. Repide,* 213 U.S. 419 (1909); *McManus v. Durant,* 168 App. Div. 643, 154 N.Y.S. 580 (1st Dep't 1915); *Fox v. Heatherton,* 281 App. Div. 748, 118 N.Y.S. 2d 156 (2d Dep't 1953); *Rosenberg v. Brodsky,* 138 N.Y.S.2d 678 (Sup. Ct., Kings Co. 1955) (not officially reported); *Agatucci v. Corradi,* 327 Ill. App. 153, 63 N.E.2d 630 (1945); *Jacquith v. Mason,* 99 Neb. 509, 156 N.W. 1041 (1916). Cf. *Childs v. RIC group Inc.,* 331 F. Supp. 1078 (N.D. Ga. 1970) and *Speed v. Transamerica Corp.,* 99 F. Supp. 808 (D. Del. 1951). The latter case shows that the officer or director has the burden of proving that the price paid to the stockholder was fair.

Because of the fiduciary relationship, the very offer of an officer or director to purchase shares of his corporation at a given price is an implied representation that the price offered was the fair price for the stock. *Speed v. Transamerica Corp.,* 99 F. Supp. 808 (D. Del. 1951). Cf. *Jaynes v. Jaynes,* 98 Cal. App. 2d 447, 220 P.2d 598, 602 (1950); *Fox v. Cosgriff,* 66 Idaho 371, 159 P. 2d 224, 227-228 (1945). Thus, not only by their concealment of material facts but also by their very act of offering to pay a price which represented only one-third to one sixth of the value

of her stock, Ritenour and Lipsky breached their fiduciary duties to Mrs. Arlinghaus.

B. *The Disclosure Duty Under Section 10[b] of The Securities Exchange Act of 1934*

Section 10(b) of the Securities Exchange Act of 1934 is implemented by Securities Exchange Commission Rule X-10B-5, which reads as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

The purpose of the Act and the Rule is "to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges . . ." *SEC v. Texas Gulf Sulphur Co., supra* at 847-848. Clearly, the sale by Mrs. Arlinghaus of the stock owned by her and her husband's estate was just the sort of inequitable and unfair transaction that Congress had hoped to thwart by passage of the anti-fraud provisions of the federal securities laws.

Nevertheless, Judge Werker held that defendants were not liable under Rule 10b-5. First, he held that Ritenour and Lipsky had made the required disclosure by reporting

to Pepper their findings as to the probable value of Teleservice. (A44). Secondly, he held that Mrs. Arlinghaus had the burden of proving that she had acted with due diligence to ascertain independently the value of the shares she was selling and that she had not met that burden. (A45).

As shown above, (*supra*, pp. 16-25), Judge Werker erred in holding that the duty of disclosure had been met. He further erred in requiring a showing of a "due diligence" investigation on the part of Mrs. Arlinghaus before allowing recovery under Section 10(b) of the Securities Exchange Act.

This Court has never held that proof of "due diligence" is an essential element of recovery under 10b-5. The concept has its origin in attempts made by two other Courts of Appeal to weed out frivolous or unjustified claims for recovery under Rule 10b-5 by imposing on plaintiffs a standard of "due care." *See Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973); and, *City National Bank v. Vanderboom*, 422 F.2d 221 (8th Cir. 1970).

Although some courts have suggested that "diligence" by the plaintiff is an independent element of a 10b-5 cause of action, see *Jackson v. Oppenheim*, CCH 1970-71 Transfer Binder, ¶93,008 (S.D.N.Y. 1971), examination reveals that they have used the concept only as an aid in judging whether the plaintiff's reliance was justified. *Vanderboom* raised the issue of "due care" incidentally as part of its discussion of reliance. 422 F.2d at 230. Since *Vanderboom*, courts occasionally have sought to employ this aspect of reliance to eliminate undeserving claims by individuals who had previous knowledge or notice of conduct in violation of 10b-5.

The only case even to suggest such a requirement in the Southern District of New York was *Jackson v. Oppenheim, supra.* In that case, Judge Cooper denied defendant's motion for summary judgment. However, he stated that, under the facts of that case, the plaintiff-insider had to prove that he had exercised due care in order to succeed on his claim under 10b-5. The plaintiff was general counsel, secretary and a director of a publishing company which bought shares in the company at an unusually low price, after which the company went into bankruptcy. Plaintiff purchased the securities despite his knowledge of a net loss for that fiscal year, and despite the fact that he had prepared a registration statement for the company which indicated an uncertain financial future. In light of the plaintiff's close familiarity with the company's operations and its financial condition, defendant argued that plaintiff should be denied relief as an insider for his failure to exercise "due diligence." The court disagreed, finding a sufficient issue of fact to deny summary judgment. However, Judge Cooper, citing *Vanderboom, supra,* stated that an insider "must exercise due care before he may claim reliance or damages based upon alleged misrepresentations or non-disclosures." *Id.* at 90,716. Thus, he considered "due care" a facet of the reliance requirement, not an independent element of 10b-5 liability. Furthermore, the Court carefully qualified its statement by explaining that

> "The reason for this rule and what constitutes reasonable or due diligence in a given case turn on factors which include the plaintiff's sophistication, expertise and business acumen in the financial community, his access to information and his opportunity to detect any fraud or wrongful conduct". *Ibid.* at 90,716.

The instant case is in its very essence different from *Jackson, supra.* Unlike the plaintiff in that case, who possessed an intimate acquaintance with the condition of the company, Mrs. Arlinghaus knew little or nothing about the make-up or financial condition of Teleservice. Jackson knew of his company's ill-health and of the dramatic decrease in the value of its shares, and he could hardly claim ignorance of those conditions which caused the bankruptcy and resulted in his 10b-5 claim. Mrs. Arlinghaus, on the other hand, had no knowledge or reasonable grounds to assume that the market value of Teleservice shares were grossly disproportionate to the offer made to her by her attorney and her late husband's closest business associates.

Unlike the plaintiff in *Jackson*, Mrs. Arlinghaus' sophistication and business acumen was nil. Entirely unfamiliar with the day-to-day operation of Modern Teleservice, much less the on-going negotiations for the sale of the company, she relied entirely upon her lawyer and agent, Pepper.

Since "due diligence" is properly subsumed under the element of reliance in a 10b-5 cause of action, in a case involving non-disclosure such as the instant case, proof of "due care" is unnecessary in the same fashion, and for the same reasons, as proof of reliance. *See Affiliated Ute v. United States*, 406 U.S. 128 (1972), and *Schlick v. Penn-Dixie Cement Corp.*, 507 F.2d 374, 380-81 (2d Cir. 1974). As is true absent proof of reliance in a non-disclosure case, requiring proof of "due diligence" from all plaintiffs seeking to recover under 10b-5 would impose an unjust and impractical barrier to recovery under an antifraud provision which is broad in scope, especially where the plaintiffs have no reason to suspect fraudulent conduct. A person like Mrs. Arlinghaus, entirely lacking in business acumen,

cannot fairly be expected to conduct a "due diligence" inquiry before making a sale of shares to her most trusted advisers.

POINT III

RITENOUR AND LIPSKY ARE JOINTLY LIABLE WITH PEPPER FOR PEPPER'S VIOLATION OF HIS FIDUCIARY DUTIES TOWARD MRS. ARLINGHAUS

It is well established that those who knowingly join with a fiduciary in the breach of his fiduciary duties become jointly and severally liable with him. *Jackson v. Smith*, 254 U.S. 586, at 589 (1920); *Irving Trust Company v. Deutsch*, 73 F. 2d 121, at 125 (2nd Cir. 1934). All that is required to hold the non-fiduciary liable with the fiduciary is (1) knowledge of the breach and (2) some benefit received from the wrongdoing (*Ibid.*). The rule was repeated in *Ripperger v. Allyn*, 25 F. Supp. 554 (S.D.N.Y. 1938):

> "One who knowingly joins a fiduciary in an enterprise where the personal interest of the latter is or may be antagonistic to his trust becomes jointly and severally liable with him for the profits of the enterprise. *Irving Trust Company v. Deutsch*, 2 Cir., 73 F. 2nd 121." 25 F. Supp. at 555.

In *Crites Incorporated v. Prudential Insurance Company*, 322 U.S. 408 (1944), a receiver of real property who knew of an interested purchaser for the property, allowed another to buy at a lower price in order to collect a commission on the resale. The Supreme Court said:

> "Any profits that might have resulted from a breach of these high standards, including the profits of others who knowingly joined him in

> pursuing an illegal course of action, would have to be disgorged and applied to the estate. *Michoud v. Giroud*, 4 How. 503; *Magruder v. Drury*, 235 U.S. 106; *Jackson v. Smith*, 254 U.S. 568." 322 U.S. at 414.

See also *Broadcast Music v. Taylor*, 10 Misc. 2d 9, 55 N.Y. Supp. 2d 94 (Sup. Ct., New York County) *Blankenship v. Boyle*, 329 F. Supp. 1089, 1102 (D.C. 1971); *Austrian v. Williams*, 103 F. Supp. 64, 77 (S.D.N.Y. 1952) rev'd on other grounds, 198 F2d 697 (2d Cir 1952); *In Re Standard Commercial Tobacco Co., Inc.*, 34 F. Supp. 304 (S.D.N.Y. 1940); *Anderson v. Daley*, 38 App. Div. 505, 56 N.Y. Supp. 511 (2nd Dept. 1899); *Muson v. Syracuse, Geneva and Corning Railroad Company*, 103 N.Y. 58, (1886).

Judge Werker found that Pepper had violated his fiduciary duties in arranging for the sale of her Teleservice stock at $10 a share. It is beyond dispute that Ritenour and Lipsky profited from the sale, and at a grand scale. The evidence is also clear that Ritenour and Lipsky had knowledge of Pepper's adverse interest and his other violations of fiduciary duties. The relevant facts are summarized *supra*, pp. 22-24.

POINT IV

MRS. ARLINGHAUS IS ENTITLED TO AN ACCOUNTING OR DAMAGES AT HER CHOICE

In her final submission of her case to the trial court, Mrs. Arlinghaus asked that the Court direct Pepper (see A 51) and Ritenour to account to her for their profits on their purchase of Teleservice shares from her. She asked for damages against Lipsky. In a rescission action, the plaintiff

may choose either remedy. *Marcus v. Otis,* 168 F.2d 649 (2d Cir. 1948); *reaff'd,* 169 F. 2d 148.

Judge Werker granted Mrs. Arlinghaus' request for an accounting against Pepper but denied all relief against Ritenour and Lipsky for the reasons discussed above.

If the Court shall reverse the judgment dismissing the claims against Ritenour and Lipsky, it follows that Mrs. Arlinghaus will be entitled to the respective reliefs against them which she requested in the trial court.

CONCLUSION

The Court should reverse the judgment of September 30, 1975 by which the district court dismissed Mrs. Arlinghaus' claims against Ritenour and Lipsky and should direct judgment in favor of Mrs. Arlinghaus against Ritenour for an accounting and against Lipsky for damages.

Respectfully submitted,

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